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IN THE

Supreme Court of the United States

October Term, 1956

No. 709

GOODING AMUSEMENT COMPANY, INCORPORATED, F. E. GOODING, ELIZABETH GOODING, *et al.*, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The petitioners named above pray that a writ of certiorari issue to review the judgments of the Court of Appeals for the Sixth Circuit entered in the above cases on August 1, 1956.

OPINION BELOW

These cases were consolidated for hearing in the courts below. The opinion of the Tax Court (R. 128a-153a) is reported at 23 T.C. 408, and the opinions of the Court of Appeals (Appendix A, *infra*, pp. 17-32) is reported at 236 F. 2d 159.

JURISDICTION

The judgments of the Court of Appeals were entered on August 1, 1956 (Appendix B, *infra,* pp. 33-36). On August 20, 1956, petitioners filed a motion with the Court of Appeals for the Sixth Circuit for an extension of time to September 15, 1956, within which to file a petition for rehearing (R. 177a). An order was entered by that court granting the requested extension of time, and petition for rehearing was filed within the time allowed (R. 177a-178a). On October 26, 1956, an order was entered by the Court of Appeals denying the petition for rehearing (R. 179a). The jurisdiction of this Court is invoked under Section 1254 of Title 28, U. S. Code.

QUESTIONS PRESENTED

The individual taxpayers, F. E. Gooding and Elizabeth Gooding, together with their daughter, Joyce Ann Gooding, were members of a partnership. A portion of the assets of this partnership were distributed to the partners as tenants in common in accordance with their interests therein. At or about the same time, the assets so distributed were offered to a newly formed corporation, the taxpayer, Gooding Amusement Company, Incorporated. In partial consideration for these assets the corporation issued to the three individuals, in proportion to their interests in the property transferred, all of its then outstanding shares of common stock; it also issued to them in like manner its negotiable, interest-bearing, promissory notes, payable at fixed dates within a period of five years, in a total amount equal to the difference between the fair market value of the property so acquired by the corpora-

tion and the stated value of $49,000 of the common stock received by them. The questions presented are:

1. Was interest on the notes paid or accrued by the corporate taxpayer deductible under Section 23(b), Internal Revenue Code of 1939, as being on an indebtedness of the corporation;

2. Were payments by the corporate taxpayer to the individuals on the principal amount of the notes repayments of indebtedness of the corporation or distributions to the individual taxpayers equivalent to dividends, under Section 115, Internal Revenue Code of 1939.

3. Was the transfer of assets by the individuals to the corporation in exchange for its stock and the negotiable promissory notes a taxable transaction, not coming within the provisions of Section 112(b)(5), Internal Revenue Code of 1939, so that the basis of the property acquired by the corporation, for the purposes of depreciation and gain or loss, was its cost to the corporation, rather than its previous basis in the hands of the individual transferors.

STATUTES INVOLVED

The statutory provisions involved are Sections 23(b), 112(b)(5), 113(a)(8), and 115 of the Internal Revenue Code of 1939, as amended. These are set forth in Appendix D, *infra,* pp. 48-50.

STATEMENT

Since about 1913 the individual taxpayer, F. E. Gooding, had been engaged in the outdoor amusement business. This business may be characterized as the supplying and operating of portable equipment, such as merry-go-rounds, ferris wheels and other entertainment devices designed for use at fairs, parks, cele-

brations, church bazaars, etc. The taxpayer first became engaged in this business as an employee of his uncle, J. E. Gooding, who had also been in the business for some 20 years prior to that time. In 1932 the taxpayer organized a corporation which operated amusement devices owned by him individually (R. 130a). On January 1, 1943, a partnership was formed by and between F. E. Gooding, Elizabeth Gooding, his wife, and Joyce Ann Gooding, their daughter, each having, respectively, a 4/7, a 2/7 and a 1/7 interest therein. The amusement devices previously owned by the taxpayer, F. E. Gooding, in his individual capacity were sold to the partnership and thereafter operated by it (R. 131a).

On August 24, 1946, the taxpayer corporation was organized with F. E. Gooding, Elizabeth Gooding and Kathleen Holleran as its president and treasurer, vice president, and secretary, respectively (R. 132a). On that same date the partnership distributed to its three partners, as tenants in common in proportion to their interests in the partnership, assets consisting of advances to employees, accounts and notes receivable, land, buildings, cables, electrical equipment, office equipment, electrical towers, trucking equipment, canvas, mechanical rides, unexpired insurance and advance payments on equipment. The assets so distributed were the operating assets of the business (R. 132a, 136a), having a book value of $177,037.29. Their fair market value was $294,970.39 (R. 132a-133a).

Concurrently, the partners made an offer to sell this property to the newly formed corporation at its fair market value of $294,970.39. The offer was accepted by the corporation. The corporation also assumed notes payable in the amount of $13,969.25, previously

assumed by the partners upon the partnership distribution (R. 133a-134a). In exchange and in partial consideration for the assets so transferred to it, the corporation issued its no par common stock to the partners in the following amounts: to F. E. Gooding, 140 shares; to Elizabeth Gooding, 70 shares; to Joyce Ann Gooding, 35 shares. The stock was stated to have a value of $200 per share or a total value of $49,000. For the remainder of the purchase price, the corporation issued to each of these three individuals five notes due in the succeeding five years beginning in 1947.[1] The notes issued to F. E. Gooding were in the face amount of $26,514.42; those to Elizabeth Gooding, in the face amount of $13,257.20; and those to Joyce Ann Gooding, in the face amount of $6,628.60. The notes issued by the corporation were ordinary negotiable judgment notes, each containing an unconditional promise to pay on a fixed date the principal thereof, together with interest at five per cent per annum. The total face amount of such notes was $232,001.14 (R. 135a).

Prior to August 24, 1946, the partnership had executed "privilege" contracts in advance from 60 days to 12 months, entitling it to the use of certain locations on which the amusement devices could be placed and operated (R. 21a). These contracts were not carried at any value on the books of the partnership as of August 24, 1946, nor were they ascribed any value on the books of the new corporation. However, they totaled approximately 51 in number, and the rights under them were conveyed to the corporation at the time of the transfer (R. 22a, 67a-68a, 136a).

[1] The payee of notes issued to Joyce Ann Gooding was F. E. Gooding, as natural guardian of Joyce Ann Gooding.

The corporation, thus, acquired rights of substantial value which were not reflected in the stated value of the tangible property transferred but which were productive of income.

The name "Gooding" was well established in the outdoor amusement business and was of substantial value in the securing of contracts for the furnishing of amusement devices; yet, no value was ascribed to good will on the books of either the partnership or the corporation (R. 136a). Testimony, which was not only uncontradicted but also based upon an exhibit offered in evidence by the Government, set the value of good will received by the corporation upon the transfer of assets at $197,843.84 and the total value of assets transferred in exchange for stock and negotiable notes at $478,844.98 (R. 117a, 121a, 146a). As stated above, the notes issued were in the total amount of $232,001.14.

Non-operating assets of the partnership in the total amount of $285,745.84 were not distributed to the partners but were left in the partnership, which continued in existence during the period here under consideration. Of this total, the sum of $184,444.23 was represented by cash; $77,498.76, by investments; $22,660.00, by land; and $1,142.85, by accrued interest income (R. 29a).

By the end of the year 1946, employees of the taxpayer corporation had acquired shares of its stock in addition to the 245 shares originally issued on August 24, 1946. At the end of the year 1947, persons other than the individual taxpayers and their daughter, including employees of the corporation, held 79 shares which represented 24.39% of the total outstanding

stock. At the end of the years 1948 and 1949, the number of shares so held was 85, and the percentage with respect to that held by the original stockholders was 22.3 and 22.2, respectively (R. 40a, 138a, 142a).

Dividends were paid by the corporation in the amount of $2 per share in 1946, $20 per share in 1947 and 1948, and $10 per share in 1949. Earned surplus, after payment of dividends and taxes, increased from $67,580.79 at the close of the year 1946 to $236,254.11 at the end of the year 1949 (R. 142a).

The face amount of the notes issued to the taxpayer, F. E. Gooding, each in the amount of $26,514.42, due in 1947 and 1948 were paid by the corporation on or about the maturity date. The note in the same amount due in 1949 was paid in the full face amount in 1950. Of the amount due on the note for $13,257.21 issued to the taxpayer, Elizabeth Gooding, and due August 24, 1947, $5,000 was paid on that date. None of the notes issued to Joyce Ann Gooding, or to F. E. Gooding as her natural guardian, were paid (R. 141a). While repayment of principal was not strictly enforced by the individual taxpayers and their daughter, there was no evidence of any formal subordination of rights under these notes to those of other creditors of the corporation (R. 67a).

For the taxable year 1946, each partner reported as a long-term capital gain his proportionate share of the difference between the book value or depreciated cost of the operating assets and the amount for which such assets were sold to the corporation. On these gains the individual taxpayers paid a total tax of $28,683.27. The income tax returns for the year 1946 of the individual taxpayers were accepted by the Gov-

ernment without the elimination therefrom of the aforesaid capital gains (R. 36a, 137a). The corporate taxpayer filed an income tax return for the period August 24, 1946 to December 31, 1946. In this return the corporation used the cost to it of the property acquired as a basis for depreciation and gain or loss. This return was accepted by the Government without challenge (R. 25a, 137a).

For the years 1947, 1948, and 1949 the corporate taxpayer accrued on its books, and claimed as a deduction on its federal income tax returns, interest on the notes mentioned above which it had issued on August 24, 1946. These amounts were $10,277.34 in 1947; $9,568.99 in 1948; and $8,698.61 in 1949. The individual taxpayers and their daughter, the owners of the notes in question, reported the above amounts as interest income received from the corporation (R. 142a).

The corporate taxpayer filed income tax returns for the calendar years 1947, 1948, and 1949. In determining the taxpayer's liability the Commissioner of Internal Revenue disallowed as a deduction interest claimed on the notes, as set forth above, and also reduced the allowance for depreciation and increased net long-term capital gains reported in these years. A notice of deficiency in income tax was mailed to the corporate taxpayer on January 21, 1952, asserting deficiencies of $9,337.59 for 1947; $6,800.58 for 1948; and $11,785.94 for 1949. The deficiencies were asserted on the grounds that the exchange of operating assets for notes was a non-taxable exchange and that the basis of the property received by the corporation should be the same as in the hands of the transferors,

and that amounts claimed as interest paid or accrued on the notes were not deductible because not paid on corporate indebtedness. (R. 1a, 16a, 129a).

The individual taxpayers, F. E. Gooding and Elizabeth Gooding, filed individual income tax returns for the year 1947 and a joint return for the year 1948. On January 21, 1952, the Commissioner of Internal Revenue mailed notices of deficiency to these taxpayers asserting a deficiency for the year 1947 against F. E. Gooding in the amount of $19,307.82 and against Elizabeth Gooding in the amount of $2,449.02, and for the year 1948 against these taxpayers jointly in the amount of $15,983.02. The proposed deficiencies against these individual taxpayers for the years 1947 and 1948 were based upon the ground that payments to them by the corporation in these years on the principal of the notes issued to them on August 24, 1946, should be included in income as dividends received. (R. 4a, 8a, 12a, 17a-19a, 129a).

The taxpayers filed petitions with the Tax Court of the United States, seeking a redetermination of the income tax deficiencies asserted against each of them for the years in question (R. 1a-15a). The determinations of the Commissioner of Internal Revenue were sustained by the Tax Court (R. 128a), and its decisions with respect to these taxpayers were affirmed (one judge dissenting) by the Court of Appeals for the Sixth Circuit (Appendix A, *infra*, pp. 17-32).

REASONS FOR GRANTING THE WRIT

I. The decision of the Court of Appeals in this case is in conflict with that of another Court of Appeals on the same matter.

II. The Court of Appeals in this case has decided an important question of Federal law which has not been, but should be, settled by this Court.

I

The Decision of the Court of Appeals in This Case is in Conflict With That of Another Court of Appeals on the Same Matter.

The decision of the Court of Appeals for the Sixth Circuit in the instant cases is in direct conflict with that handed down by the Court of Appeals for the Ninth Circuit on December 27, 1956, in the case of *Estate of Herbert B. Miller* v. *Commissioner*. That case is not yet officially reported, but a copy of the court's opinion is attached hereto as Appendix C, *infra*, pp. 37-47. In that case, three brothers who had conducted a paint business in partnership for several years prior to 1946 decided at that time to incorporate. Pursuant to a pre-arranged plan, the brothers transferred to the newly formed corporation the operating assets of the partnership with some cash, and took in equal parts the shares of common stock and notes of the corporation. As in the present cases, payments were made on these notes during the years in question, such payments being made out of income received and earned by the corporation. These payments were treated as a return of principal by the taxpayer.

The Commissioner of Internal Revenue, however, challenged this treatment, holding that the notes issued by the corporation to the taxpayer and his brothers did not represent *bona fide* indebtedness and that payments which were purportedly made on the notes constituted in fact distribution of taxable dividends by the corporation. The Tax Court sustained this posi-

tion of the Commissioner (24 T.C. 923). The Court of Appeals for the Ninth Circuit, however, held that the assessment of deficiency on this ground was erroneous, and reversed the decision of the Tax Court. Except for perhaps some insignificant details, the situation in the *Miller* case is indistinguishable from that presented by the case of the present taxpayers. In any event, the legal principles applied by the two courts are in direct conflict and should be resolved by this Court.

The decision of the Court of Appeals for the Sixth Circuit is also in conflict with that of the Court of Appeals for the Fifth Circuit, in the case of *Sun Properties, Inc.* v. *United States*, 220 F. 2d 171. There, as here, the question for determination was the basis for depreciation of property transferred to a new corporation by a stockholder. The corporation in that case was formed by a sole stockholder on August 25, 1947, with three shares of stock being issued, one to him and two to nominees, in exchange for one dollar paid by each as the capital of the corporation. Three days later the two shares of stock were purchased from the nominees, and, two days after that, two lots were deeded by the sole stockholder to the corporation at a listed value of $400, in exchange for the remaining seven shares of stock. Two weeks later, the sole stockholder transferred to the corporation a warehouse building for an alleged consideration of approximately $125,000. This consideration was to be paid off by the corporation at the rate of $4000 semi-annually, with no provision being made for interest, down payment, or security by way of mortgage. Since the corporation had only nominal assets other than the warehouse, it was the sole operating asset, and the

purchase payments were to be made out of rentals subsequently received. A deficiency was asserted against the corporation by the Commissioner of Internal Revenue on the ground that the transfer of the warehouse to the corporation by the sole stockholder was not a sale but a contribution to capital of the corporation and that, accordingly, the basis for depreciation of the property in the hands of the corporation should be the same as it has been in the hands of the transferor. The taxpayer paid the deficiency and sued for refund. The determination of the Commissioner was upheld by the District Court for the Southern District of Florida (December 18, 1953, 1954 P.-H. ¶72,736, 1954-2 USTC ¶9528), but was reversed by the Fifth Circuit.

The decision of the Sixth Circuit is also in conflict in principle with that of the Court of Appeals for the Second Circuit in the case of *Kraft Foods Company* v. *Commissioner*, 232 F. 2d 118. That case did not involve the organization of a new corporation but did involve the question of the validity of corporate indebtedness to a sole stockholder for the purpose of taking the deduction for interest allowed by Section 23(b) of the Revenue Acts of 1934, 1936 and 1938. There the taxpayer, in 1934, declared a dividend payable in 6% debentures due February 1, 1948, and claimed as a deduction under Section 23(b) the portions of its earnings paid to its sole stockholder as interest on the debentures. This was disallowed by the Commissioner, whose determination was sustained by the Tax Court (21 T.C. 513). The Second Circuit reversed the order of the Tax Court and allowed the interest deduction.

Not only is the decision of the Court of Appeals for the Sixth Circuit in these cases in conflict with those

of the Ninth, Fifth and Second Circuits, but it is also in conflict with decisions of the Tax Court, regarding indistinguishable factual situations, in which not only has no appeal been taken but also the Commissioner of Internal Revenue has acquiesced. See *John W. Walter, Inc.* v. *Commissioner,* 23 T.C. 550 (Acq., 1955—2 Cum. Bull. 10) and *Sheldon Tauber* v. *Commissioner,* 24 T.C. 179 (Acq., 1955—2 Cum. Bull. 9).

II

The Court of Appeals in This Case Has Decided an Important Question of Federal Law Which Has Not Been, But Should be, Settled by This Court.

It is not entirely correct to say that the question of the deductibility of interest by a corporation on obligations issued to stockholders, all of whom are members of a family group, has never been before this Court. The question was presented in the case of *John Kelley Co., et al.* v. *Commissioner,* 326 U.S. 521, where this Court had granted certiorari "on account of the diversity of approach in the Tax Court and the reviewing courts." The decision of this Court in that case, however, was based entirely upon the *Dobson* rule[2]; it not only did not settle the basic issues, but left in effect the conflicting decisions of the Tax Court. That case was in reality a reaffirmation of a rule governing the scope of review, which has subsequently been changed by statute (Act of June 25, 1948, c. 646, 62 Stat. 870).

The questions presented by these cases are of basic and paramount importance to the business community. Though not unknown to larger businesses, they affect

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[2] *Dobson* v. *Commissioner,* 320 U.S. 489.

in particular small business where there are decisions to be made as to the form in which the enterprise will be conducted, whether as a partnership, a sole proprietorship, or as a corporation, and where problems with respect to financing are much more acute. The conflicting decisions in the lower courts present just as great a problem in this area as did those in the family partnership cases several years ago.[3] These decisions, disallowing interest deductions, denominating payments on notes as dividends, and redetermining the basis of property transferred by individual stockholders to corporations, are apparently inspired by the same reasoning used in those cases—a fear, or almost a presumption, of a lack of reality because of the closeness of relationship between partners or, as here, stockholders and creditors. This Court granted certiorari to resolve the multitude of conflicting decisions in the family partnership area and, in the now famous case of *Commissioner* v. *Culbertson,* 337 U.S. 733, set forth certain tests by which the validity of such arrangements might be determined. It appears in this area of family or closely held corporations, no less than in that of family partnerships, that, as Justice Frankfurter said in the *Culbertson* case (p. 749),

> * * * it is due to the Tax Court, the Courts of Appeals, the Treasury and the bar to make more explicit what the appropriate legal criteria are.

That guidance in this area is expected, or anticipated, by the Courts of Appeals is reflected in the statement in the dissenting opinion of Chief Judge

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[3] The cases are already piled up like flies matted in some tangled web. For a definitive discussion of this whole problem, see Bittker, "Thin Capitalization: Some Current Questions", 34 Taxes 830 (Dec. 1956).

Clark in the case of *Kraft Foods Company* v. *Commissioner, supra,* (p. 129) that "* * * we are but a station on the way to definitive exposition by the Supreme Court, * * *."

No better reason for review or for granting a writ of certiorari in these cases can be given than that expressed by the late Justice Rutledge in his opinion (concurring in part and dissenting in part) in *John Kelley Co., et al* v. *Commissioner, supra,* (pp. 535-536):

> Something more is at stake in these cases than nice distinctions between "stock" and "bonds" on the one hand or between ultimate conclusions of "fact" and "law" or "mixed fact and law," on the other, just as was true in the conveyancing cases. The border cutting across one set of normally opposing conceptions may be deliberately obscured and made into a no man's land as readily as that involved in the other. When this happens, the final link in the chain of judgment is decisive, whatever its label.[7] If the ultimate conclusion of the Tax Court or its divisions can be made in exactly opposing ways, and must be left undisturbed, without substantial differentiating facts, or when hybrid arrangements bear tax indicia equally with marks of non-taxability, not only is the statutory review nullified. The right of taxpayers to be treated with equal justice before the law is denied.

[7] The legal element is not eliminated merely because it appears in "a molecular combination of fact and law which defies separation." *Berry* v. *Irving Place Corp.*, 52 Fed. Supp. 875, 881. It may be the dominant element in the combination. When it is, minutiae of factual difference should not govern result or sustain conflicting outcomes.

CONCLUSION

For the reasons stated, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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APPENDIX

APPENDIX

APPENDIX A

Nos. 12574-5-6-7

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 12574

GOODING AMUSEMENT COMPANY, Incorporated, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 12575

F. E. GOODING, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 12576

ANNA ELIZABETH GOODING, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 12577

F. E. GOODING and ELIZABETH GOODING, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION to Review Decisions of the Tax Court of the United States.

Decided August 1, 1956.

Before SIMONS, Chief Judge; MARTIN and MCALLISTER, Circuit Judges.

MARTIN, Circuit Judge. These four tax reviews, involving transactions among F. E. Gooding, his wife Anna Elizabeth Gooding, and his controlled corporation, Gooding Amusement Company, were consolidated for hearing and resulted in decisions by the Tax Court of the United States that there are deficiencies in income tax, varying in amounts as to the respective parties, relating to the years 1947, 1948 and 1949, in the aggregate amount of $65,663.88.

The findings of fact and opinion of the tax judge were reviewed by the tax court. Many facts were stipulated and embraced in the findings. The tax court received in evidence the testimony of the taxpayer, F. E. Gooding, and that of a certified public accountant, Edmund C. Redman. A review of the findings of fact deemed pertinent to decision will be undertaken; but we shall not incorporate the several mathematical tabulations contained therein, or otherwise indulge in unnecessary detail.

In late December of 1932, F. E. Gooding organized a corporation to lease and operate merry-go-rounds, ferris wheels, and like amusement devices, which were owned by him individually. This corporation was dissolved on December 31, 1942. During 1942, petitioner employed as tax consultant a certified public accountant who has been associated with his business since that time.

On January 1, 1943, F. E. Gooding formed a partnership with his wife and their one-year-old daughter under the name and style of "F. E. Gooding Amusement Company." Gooding gave his wife two-sevenths' interest and his baby daughter a one-seventh interest in the partnership, retaining for himself the remaining four-sevenths' interest therein. The petitioners accepted the determination of the Bureau of Internal Revenue that the infant daughter was not a *bona fide* partner for in-

come tax purposes. Accordingly, her one-seventh interest in the partnership was taxed to her father for the years 1943 to 1946, inclusive. Gooding sold the amusement devices and portable rides to the partnership, which operated them rent free. The partnership carried public liability insurance to the extent of $50,000, which Gooding considered as going "a long way" toward covering any liability which might arise from accidents in the operation of the property of the partnership. The largest accident claim ever paid amounted to $18,000. The net taxable yearly income of the partnership from January 1, 1943, to August 24, 1946, ranged from $151,000 to $257,000, approximately.

On August 24, 1946, a corporation known as "Gooding Amusement Company, Incorporated," was organized, the officers being F. E. Gooding, President and Treasurer; Elizabeth Gooding (his wife), Vice-President; and Kathleen Holleran, Secretary. At the close of business on that date, the Gooding partnership distributed to its three partners—as tenants in common in respective moieties of four-sevenths to F. E. Gooding, two-sevenths to his wife, and one-seventh to his infant daughter—assets of the partnership consisting of accounts and notes receivable, land, buildings, cables, canvas, electrical, trucking, and office equipment, electrical towers, mechanical rides, unexpired insurance, advance payments on equipment, and advances to employees. The book value of the assets so distributed was $177,037.29; and the book value of the undistributed cash investments, land and accrued interest of the partnership was $285,745.84. Each partner, in proportion to his or her respective undivided interest in the distributed assets, assumed a joint and several obligation to pay certain notes executed by the partnership in the total amount of $13,969.25. The capital account of each partner was proportionately reduced on the books, with the effect that the net total distribution was $163,068.04, which was equivalent to the book

value of the assets distributed, less the notes payable assumed.

The partnership remained in existence throughout the entire period involved in this litigation. Included in the assets distributed to the partners were depreciable assets, whereof nearly $130,000 consisted of trucking equipment and mechanical "rides."

Concurrently with the distribution of the partnership assets of the book value of $177,037.29, the partners made an offer to the newly formed corporation, Gooding Amusement Company, to exchange the aforementioned distributed assets at a valuation of $294,970.39. The difference between the depreciated book value of the distributed assets and the amount offered came to $117,933.10. This represented the difference between the book value of the trucking equipment and mechanical rides and the fair market value of such assets as appraised by Gooding with the help of Kathleen Holleran, secretary of the corporation. In arriving at the new valuations, Gooding surveyed the equipment and rides in use on the various locations, checked inventory records, and consulted with his foremen concerning the condition of the equipment and rides. The new corporation assumed the partnership notes, amounting to $13,969.25, the payment of which had previously been assumed by the three partners.

In return for the foregoing assets amounting by net balance to $281,001.14, transferred and conveyed to the corporation, the three partners received in proportion to their respective partnership interests corporate shares of no-par value and corporate notes of the Gooding Amusement Company. F. E. Gooding received 140 shares having a stated value of $28,000 and five notes due in five succeeding years (beginning in 1947) of $26,514.42 each, totaling $132,572.08; Elizabeth Gooding received 70 shares having a stated value of $14,000 and five notes

due in five succeeding years (beginning in 1947) of $13,257.20, for a total of $66,286.04; and the infant daughter, Joyce Ann Gooding, received 35 shares having a stated value of $7,000 and five notes due in five succeeding years (beginning in 1947) of $6,628.60 each, totalling $33,143.02. The portion of the assets contributed for the shares and that contributed for the notes was not identified. The corporate notes were ordinary negotiable instruments, each containing an unconditional promise to pay at a fixed maturity date the principal promised, together with interest at five per cent per annum. The notes to the infant daughter were made payable to "F. E. Gooding as natural guardian of Joyce Ann Gooding." Though the name "Gooding" was of established value in the outdoor amusement field, no goodwill value was ascribed to it on the books of either the partnership or the corporation. The sum of $184,444.23 in cash was left in the partnership among its non-operating assets totalling $285,745.84. The corporation received no cash whatever from the partnership.

Each partner reported for the taxable year 1946, as a long-term capital gain, his or her proportionate share of the difference between the depreciated cost of the transferred assets and the amount at which such assets were offered to and accepted by the corporation. The individual petitioners paid a total tax of $28,683.27 on these long-term capital gains, which the Commissioner of Internal Revenue accepted.

The corporation used as the unadjusted basis of the trucking equipment and mechanical rides acquired from the partnership on August 24, 1946, the increased valuation assigned to them by Gooding. Between August 24, 1946, and December 31, 1952, the corporation sold about fifteen per cent of its trucking equipment and fifty-seven per cent of its mechanical rides acquired from the partnership on August 24, 1946. The corporation acquired

new equipment and rides at a total cost of $306,894.27 during 1947. For the acquisition of additional equipment in 1947 and in later years, and in connection with its operation, the corporation obtained funds and credits evidenced by notes from banks, merchants, the partnership, the petitioner, and the Gooding infant. These notes payable amount in 1947 to $138,572.08; in 1948 to $186,018.92; and in 1949 to $246,149.40. During 1947, the partnership and Gooding's infant daughter advanced to the corporation the additional sum of $23,000, whereof $17,000 was outstanding at the close of both years 1947 and 1948; and $14,000 was outstanding at the close of 1949.

By agreement of date December 20, 1946, certain key employees of the corporation, in consideration of corporate shares issued to them, gave the corporation an option to repurchase the shares at any time at progressively increasing prices, beginning with $220 per share in 1947 and ending with $400 per share in 1956, at the close of which latter year the option would expire unless extended by mutual consent. At the end of 1947, the employees had acquired approximately twenty-five per cent of the corporation's outstanding stock. As of December 1953, the corporation had paid Mrs. Gooding only $5,000 on the series of five notes of $13,257.21 each issued to her by the corporation; and had made no payments on the series of five notes of $6,628.60 each payable to the infant daughter. The corporation still owed F. E. Gooding two notes of $26,514.41 each. All the unpaid notes payable to the Goodings were long past due. F. E. Gooding had been paid by the corporation three notes of $26,514.42 each for the reason, stated by him, that, unlike his wife and daughter, he needed money for investment in an apartment house.

We come now to a controversial and crucial finding of fact by the tax court. This finding was, as follows:

"The principal amount of the other notes issued August 24, 1946, was not paid because the corporation was heavily indebted to outsiders and at no time during the period involved had a sufficient cash balance. Petitioner, who as president and majority stockholder controlled the corporation, subordinated the claims of himself and his family to those of banks and other third parties. Petitioner felt that such subordination was necessary in order to maintain the corporation's credit standing. Petitioner and his family at no time had any intention of enforcing their matured claims against the corporation."

Petitioners urge that there was no subordination of their notes by any written or oral agreement; but, at most, only permission by the noteholders that payment of their obligations be deferred for the time being and that other existing creditors be actually paid before them. They point out that Gooding testified that collection of their notes was not enforced on the due dates, for the reason that they wanted the corporation to pay its outside bills promptly to preserve a good credit rating; and that the payment of the obligations to his family could be put off without inconvenience.

Contrariwise, the tax court reasoned in its opinion that it could not ascribe to F. E. Gooding an intention at the time of the issuance of the notes ever to enforce their payment, especially if to do so would impair the credit rating of the corporation, or cause it to borrow from other sources the necessary funds to pay the notes to him and his family, or bring about the dissolution of the corporation. Its opinion pointed out that a realistic appraisal of the family situation could lead only to the conclusion that petitioner's wife and infant daughter never contemplated acting independently of, or contrary to, Gooding's wishes in respect of the enforcement or disposition of their corporate notes. It was asserted that the fact that most of the notes have not been paid,

though long since matured, lends corroboration to the court's finding that at no time did the family noteholders intend to enforce payment of their notes or to assert the rights of *bona fide* creditors. The state of mind of the family noteholders was considered to be akin to that of an ordinary shareholder who understands that his investment is subject to the risk of the venture, and to the prior claims of creditors. The tax court added: "The incidence here of the subordination of the Goodings' notes to the claims of others is too marked to permit us to find that a bona fide debtor-creditor relationship was established between the corporation and its controlling stockholders."

The tax court found that there had not been established between the corporation and the individual members of the Gooding family the relationship of debtor-creditor in respect of the issuance of the corporate notes to them as of August 24, 1946; and that the payments made by the corporation to the individual petitioners in 1947 and 1948 on the principal of their notes were essentially equivalent to taxable dividends under section 115(a) of the Internal Revenue Code. The tax court held, moreover, that the accruals and payments on the notes issued by the corporation to the Goodings did not constitute interest on indebtedness under section 23(b) of the Internal Revenue Code, and therefore were not deductible from the gross income of the corporation, Gooding Amusement Company.

The further holding of the tax court was that the property acquired by the corporation in exchange for its stock in the foregoing notes was acquired in a transaction described in section 112(b)(5), Internal Revenue Code, wherein no gain or loss is recognized under the law applicable to the year in which the transfer was made; and that the basis of the transferred property is the same as it was in the hands of the transferors and

may not be increased by the amount of gain which was in fact recognized through error and on which Gooding, his wife, and infant daughter paid a capital gains tax. The case was considered just another in a long series wherein the stockholders of a closely held corporation have attempted to establish between themselves and the corporation the relationship of creditor-debtor. The companion cases, *John Kelly Co.* v. *Commissioner of Internal Revenue*, and *Talbot Mills* v. *Commissioner of Internal Revenue*, 326 U. S. 521, were cited as principal authority. It is true that the principle of *Dobson* v. *Commissioner*, 326 U. S. 489, may have been controlling in decision of the two cases cited; and the *Dobson* case no longer has the same force which it once had, in view of U. S. C. A., Title 26, section 1141(a). Nevertheless, the courts must still give appropriate consideration to the superior opportunity enjoyed by the trier of facts to judge the credibility of witnesses and to draw inferences from their testimony.

It was pointed out by the tax court that the courts have been careful not to lay down any all-embracing rule of general application in deciding each case upon its own peculiar facts but have invoked and relied upon certain criteria, none of which, of itself, is determinative of the ultimate fact question. It was said that, while the instruments involved in the instant case present in form pure evidence of indebtedness, substance must always prevail over form; and that all surrounding circumstances to determine the real intention of the parties must be considered.

The court rejected the argument of Gooding that he desired that he and his family should become substantial creditors on the same basis as other unsecured creditors, inasmuch as should a disastrous accident occur with the ensuing heavy liability he and his family would, as creditors, be able to salvage some portion of the cor-

porate assets, which they could not salvage if they were merely stockholders. The destructive answer to this argument was that, at the end of 1942 when the risk of massive liability for accidents was no less than in 1946, Gooding changed his form of doing business from that of a corporation to that of a partnership.

The tax court reasoned, moreover, that the corporation's liability insurance in 1948 and 1949 was $50,000/-200,000, an insurance carriage considerably in excess of that of the partnership and more than adequate to cover any claim which might reasonably have been expected to arise out of an accident. The stark fact was stated to be that the only substantial purpose motivating Gooding was tax avoidance. The conclusion was repeated that no indebtedness, in the meaning of section 23(b), Internal Revenue Code, arose between the Goodings and the corporation; and, there being no such indebtedness, that the accruals could not represent interest.

Upon the same reasoning the tax court concluded that, inasmuch as the notes did not in reality represent creditor interests, the payments made to the stockholders who held the notes must be deemed not to be payments of a *bona fide* indebtedness of the corporation but as a distribution of corporate profits to the stockholders, as such, and not as creditors. Accordingly, the payments constituted dividends under the broad coverage of section 115(a) of the Internal Revenue Code. The language of the United States Court of Appeals in *McGuire* v. *Commissioner of Internal Revenue,* 84 F. (2d) 431, 432 (C. A. 7), was quoted: "Neither artifice, subterfuge, nor bad faith need be present to bring a transaction within the meaning of the statute here involved, for as we read the law a taxpayer may well act with the utmost good purpose and without evil intent and yet his transactions may in effect be the equivalent of the distribution of a taxable dividend."

Finally, the tax court rejected the contention of the petitioner corporation that the exchange involved did not fall within the ambit of section 112(b)(5) but on the contrary was a transaction taxable in part under section 112(c)(1) of the Code of 1939, and that therefore the basis of the assets so transferred to the corporation includes, pursuant to section 113(a)(8), Internal Revenue Code of 1939, the amount of gain thus recognized. The tax court thus replied to this argument: "Such conclusion is a non sequitur, with which we disagree. As a condition precedent to the application of section 113(a)(8), supra, it is first necessary that compliance be had with the section 112(b)(5) requirement. That is to say, the property involved must have been acquired by the corporation by issuance of stock '... in connection with a transaction described in section 112(b)(5)....' Since we have found hereinabove that the notes which were received by petitioners and which by them are claimed to represent '. . . other property . . .' under section 112(c)(1), were in fact representative of risk capital invested in the nature of stock, the '. . . solely in exchange for stocks or securities . . .' requirement of section 112(b)(5) was, in our considered judgment, satisfied. Furthermore, immediately after the exchange the transferors were in control of the transferee corporation, and the stock which they received was in proportion to their interests in the property prior to the exchange. Thus in our opinion, the exchange involved was a so-called section 112(b)(5) transaction, as a result of which no gain or loss should have been recognized." It was stated that the court had no alternative to the denial of the stepped-up basis sought by the petitioner corporation.

We agree with the assertion in *McGuire* v. *Commissioner of Internal Revenue, supra,* that there are many holdings of the courts wherein distributions have been held not to be taxable and many other holdings where

distributions have been held to be taxable; and that most of the authorities are of little value in the determination of a particular case, for the reason that "each depends for its solution upon its own peculiar facts," to be determined in the light of all the surrounding circumstances. See also *Washmont Corporation* v. *Hendricksen*, 137 F. (2d) 306, 308 (C. A. 9); *Wetterau Grocer Co.* v. *Commissioner of Internal Revenue*, 179 F. (2d) 158 (C. A. 8); *Commissioner of Internal Revenue* v. *Meridian & Thirteenth Realty Co.*, 132 F. (2d) 182, 185 (C. A. 7). This being true, we think that no good purpose would be served by entering upon a review of the decided cases relating to the instant subject matter. For correct understanding, the facts of each case would need to be stated at some length. We think a bare citation of some of the leading cases will suffice.

In the following listed cases, distributions by the respective corporations were held to fall within the classification of dividends rather than that of interest; or advances to the corporation by principal stockholders were held to be contributions to capital and not loans to the corporation. *First Mortgage Corporation of Philadelphia* v. *Commissioner of Internal Revenue*, 135 F. (2d) 121 (C. A. 3); *Wetterau Grocer Co.* v. *Commissioner of Internal Revenue*, 179 F. (2d) 158 (C. A. 8); *Matthiessen* v. *Commissioner of Internal Revenue*, 194 F. (2d) 659, 661 (C. A. 2); *Commissioner of Internal Revenue* v. *Meridian & Thirteenth Realty Co.*, 132 F. (2d) 182 (C. A. 7); *Grace Bros.* v. *Commissioner of Internal Revenue*, 173 F. (2d) 170 (C. A. 9); *John Wanamaker Philadelphia* v. *Commissioner of Internal Revenue*, 135 F. (2d) 644 (C. A. 3).

In the following listed cases, the reverse was true and the corporate distributions were held to be in the nature of interest rather than possessing attributes of dividends; or advances to the corporation by stockholders were held

to be loans to the corporation and not contributions to capital. *Bowersock Mills & Power Co.* v. *Commissioner of Internal Revenue,* 172 F. (2d) 904 (C. A. 10; one judge dissenting); *Earle* v. *W. J. Jones & Son,* 200 F. (2d) 846 (C. A. 9); *Washmont Corporation* v. *Hendricksen,* 137 F. (2d) 306 (C. A. 9); *Rowan* v. *United States,* 219 F. (2d) 51 (C. A. 5); *Helvering* v. *Richmond, F. & P. R. Co.,* 90 F. (2d) 971 (C. A. 4); *Wilshire & Western Sandwiches, Inc.* v. *Commissioner of Internal Revenue,* 175 F. (2d) 718 (C. A. 9); Cf. *Commissioner of Internal Revenue* v. *O. P. P. Holding Corporation,* 76 F. (2d) 11 (C. A. 2); *Commissioner of Internal Revenue* v. *Page Oil Co.,* 129 F. (2d) 748 (C. A. 2).

A study of the foregoing authorities impels the thought that no rule of thumb may be derived from them, but that each particular case must be adjudicated upon its own facts. The same underlying principles are recognized in the foregoing authorities, irrespective of the divergent results reached. It is obvious that the correct application of the fundamental principles is often difficult.

This court in *United States* v. *Title Guarantee & Trust Co.,* 133 F. (2d) 990 (C. A. 6), affirmed the judgment of the district court that payments on certain certificates designated as preferred stock should be treated as interest payments on indebtedness and not as dividends on stock and were therefore properly deductible from gross income for tax purposes pursuant to Title 26, section 23, U. S. C. A. There were three separate opinions. The majority opinion pointed out that the decisive factor, in determining whether a relationship of debtor-creditor had been established or whether a stockholder relationship has been shown, depends upon the *real intention* of the parties. Such intention may be established by evidence *aliunde.* It was stated that the cases are in agreement to the effect that the decisive factor is not what payments are called, but what they are, in fact. A fixed maturity date was

said to be the most significant factor toward determining the existence of a debtor-creditor relationship. It was recognized that the findings of fact of the district court are presumptively correct and in the absence of challenging the evidence cannot be questioned on appeal. The concurring opinion rested upon this proposition. Rule 52(a), Federal Rules of Civil Procedure, was invoked in the opinion of the concurring judge: "In the absence of the evidence upon which the court made its findings we are unable to say that they were clearly wrong." The opinion of the dissenting judge asserted: "In my judgment the opinion and the findings of fact demonstrate that the taxpayer did not sustain the burden of showing that these payments were regarded by the parties as interest upon a debt. The contention of the Government that the findings of fact do not support the court's conclusions of law should therefore be sustained."

It is accepted doctrine that the findings of fact made by the tax court, unless clearly erroneous should not be set aside on review by courts of appeals. Rule 52(a) of the Federal Rules of Civil Procedure is applicable to the findings of the tax court. The courts of appeals have jurisdiction to review decisions of the tax court in the same manner and to the same extent, insofar as the facts are concerned, as the appellate courts have to review decisions of the district courts in civil actions tried without juries. *Omaha National Bank* v. *Commissioner of Internal Revenue,* 183 F. (2d) 899, 902 (C. A. 8); *Grace Bros.* v. *Commissioner of Internal Revenue,* 173 F. (2d) 170, 173 (C. A. 9); *Earle* v. *W. J. Jones & Son,* 200 F. (2d) 846 (C. A. 9); *Matthiessen* v. *Commissioner of Internal Revenue,* 194 F. (2d) 659, 662 (C. A. 2). Particularly applicable here is the succinct saying of the Supreme Court in *United States* v. *Yellow Cab Co.,* 338 U. S. 338, 341: "Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them."

Upon the entire record in the case and upon application of the principles of the authorities heretofore cited, we are of opinion that the findings of fact of the tax court are supported by substantial evidence and are not clearly erroneous, and that its conclusions were appropriately drawn.

The decision of the tax court in each of the four cases under review is, accordingly, affirmed.

McAllister, Circuit Judge, dissenting. The sole issue in this case is whether the notes executed by the corporation to petitioners constituted an indebtedness of the corporation. It is conceded that the corporation received full value in property for the notes. The price was fair. The notes are straight promissory notes. They were always reflected on the books of the corporation as indebtedness; and they were always reflected as indebtedness upon any financial statement given out for any purpose. Interest was accrued and paid each year upon the unpaid notes. Several of the notes were paid prior to the time the Commissioner indicated that he would not recognize the notes as indebtedness.

It is said by the Tax Court that the subordination of petitioners' notes to the claims of others is too marked to permit a conclusion that the notes constituted a bona fide indebtedness. Yet there was never any subordination, in a legal sense, of the notes to the claims of others. The fact that the Goodings temporarily withheld enforcement of their claims as creditors in order to assist the company in difficult times is not a circumstance that should be considered as depriving them of their standing as creditors. They had the right to share equally with other creditors, and their forebearance does not change their status. Petitioner corporation borrowed considerable money from the banks, but the corporation always showed petitioners' notes as an indebtedness when it borrowed. The banks and all creditors who relied upon the corporation's finan-

cial statement were informed that the corporation was indebted on these notes. If the banks repeatedly loaned money to the corporation, recognizing these notes to be an outstanding indebtedness, at the time; if the creditors extended credit to the corporation, knowing that these notes were carried as an indebtedness at the time such credit was extended; and if the stockholders and the corporation itself recognized these notes as a real and bona fide indebtedness, I am unable to see how the Tax Court could find that the corporation and the holders of such notes never intended them to be an indebtedness of the corporation. Such findings, in my view, are without any support in the evidence; and I am unable to see that there is any evidence from which reasonable inferences could be drawn that the parties did not intend that the notes should create a bona fide indebtedness. In fact, all of the evidence supports the conclusion that it was intended that the notes be executed in payment for the property conveyed, and that they were intended to constitute a bona fide indebtedness of the company.

In my opinion, the decision of the Tax Court was clearly wrong, and should be reversed.

APPENDIX B

Judgments of the Court Below

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 12,574

Filed August 1, 1956

GOODING AMUSEMENT COMPANY, INCORPORATED

v.

COMMISSIONER OF INTERNAL REVENUE

Before: SIMONS, Chief Judge, MARTIN and MCALLISTER, Circuit Judges.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

APPROVED FOR ENTRY:

/s/ JOHN D. MARTIN
U. S. Circuit Judge

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 12,577

Filed August 1, 1956

F. E. GOODING AND ELIZABETH GOODING

v.

COMMISSIONER OF INTERNAL REVENUE

Before: SIMONS, Chief Judge, MARTIN and MCALLISTER, Circuit Judges.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

APPROVED FOR ENTRY:

/s/ JOHN D. MARTIN
U. S. Circuit Judge

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 12,576

Filed August 1, 1956

ANNA ELIZABETH GOODING

v.

COMMISSIONER OF INTERNAL REVENUE

Before: SIMONS, Chief Judge, MARTIN and MCALLISTER, Circuit Judges.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

APPROVED FOR ENTRY:

/s/ JOHN D. MARTIN
U. S. Circuit Judge

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 12,575

Filed August 1, 1956

F. E. GOODING

v.

COMMISSIONER OF INTERNAL REVENUE

Before: SIMONS, Chief Judge, MARTIN and MCALLISTER, Circuit Judges.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

APPROVED FOR ENTRY:

/s/ JOHN D. MARTIN
U. S. Circuit Judge

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 15,031

Dec. 27, 1956

Estate of HERBERT B. MILLER, Deceased, UNITED STATES NATIONAL BANK OF PORTLAND, (Oregon), Administrator, d.b.n., c.t.a., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petitions to Review Decisions of the Tax Court of the United States

Before POPE, CHAMBERS and HAMLEY, Circuit Judges.

POPE, Circuit Judge.

The Tax Court upheld the Commissioner's determination of a deficiency in petitioner's income taxes for the calendar years 1946-1947. Prior to 1946, Miller Paint Co., was a partnership, composed of three brothers, who, as sole owners of the partnership business, had inherited it from their father. The partnership operated a store business selling paint and related products at retail and wholesale and did some manufacturing of paint. The partnership's only property was personal property. It carried on its business on premises leased from another partnership composed of the same members.

In May, 1946, pursuant to a pre-arranged plan, the members of the partnership organized a corporation, and transferred to it the operating assets of the partnership

with some cash, and took in equal parts, the shares and notes of the corporation. Payments were made on these notes in the years in question; such payments being made out of income received and earned by the corporation. Petitioner's decedent treated the payments received as a return of principal. The Commissioner's finding of a deficiency is based upon his challenge of this treatment. His position was that the notes issued by the corporation to the taxpayer and his brothers did not represent bona fide indebtedness, and that the payments which were purportedly made on the notes, constituted in fact distribution of taxable dividends. The Tax Court sustained this position of the Commissioner.

The facts upon which the Tax Court's decision was based are stated in its opinion, 24 T.C. 923. In main outline they disclose that while the business was conducted by a partnership, it had grown and prospered and continued to earn substantial profits. In 1943, two of the partners learned that the third, Herbert Miller, the decedent, was suffering from cancer, and that he had but a limited time to live. Herbert knew he was seriously ill. The brothers proceeded to endeavor to work out a plan whereby the business could continue without interruption in the event of the death of one of the partners. They rejected the suggestion for the creation of a trust to carry on the business and decided to form a corporation and to transfer to that corporation the assets necessary to carry on the business.

Herbert was the only brother who had a child. Another brother, Ernest wanted to be able to leave his share of the business in the event of his death to some of the old employees. Having these circumstances in mind, all three of the partners consulted an attorney and sought his assistance in working out an arrangement that would accomplish these objectives. During the same time the same attorney prepared Herbert Miller's will. Herbert wanted

to get some of his assets out of the company so that he could dispose of them by a testamentary trust or testamentary disposition to his widow in case of his death. The attorney was also informed of Ernest's desire to get a portion of his assets out of the company as he wanted to leave the paint business proper to some of the old employees upon his death. There was some discussion of leaving the business in the partnership and taking out insurance policies for the widow of the decedent but it was finally concluded to organize a corporation and so the parties proceeded as follows: they organized an Oregon corporation under the name of Miller Paint Co., Inc., with authorized capital of 300 shares of no par stock, and contributed as initial capital investment, the sum of $1050, ($1000 was the minimum amount required by Oregon law). Each brother took 100 shares of stock at a stated value of $3.50 per share, and paid his one third of the $1050 from his own funds. The corporation then borrowed $50,000 from the three brothers and executed a three year promissory note therefor bearing interest at 5 per cent per annum. The corporation then purchased from the brothers at inventory value substantially all of the tangible assets of the firm.[1] The fair market value of those assets was $86,622.49, and a corporation note for such amount was issued payable in annual installments of no less than $20,000, and bearing interest at 5 per cent per annum. The corporation then purchased certain petty cash and in-

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[1] The findings list these items as follows:

"Fair Market Value on June 1, 1946—

"Item	
"Inventory	$60,122.49
"Machinery and Equipment	15,000.00
"Furniture and Fixtures	3,000.00
"Delivery Equipment	7,500.00
"Office Equipment	1,000.00
"Total	$86,622.49"

tangible assets from the partnership and assumed the firm's accounts payable. The net fair market value of what the corporation thus acquired was $37,948.77,[2] and a note in that amount was given to the partners. This note also bore interest at five per cent per annum. It was payable six years from date. The corporation gave a chattel mortgage upon its personal property as security for the last two notes mentioned. Some 60 days later these three notes were cancelled and in lieu thereof new notes were issued to each partner separately. The aggregate amount of the notes was $174,571.26.[3]

It is also necessary to a full understanding of what the parties here contemplated to note the history of the Miller Paint Co. and the character of the business which passed to the corporation at the time when these arrangements were completed in May and June, 1946. The three brothers had been operating the business for some 25 years. When it passed to them from their father it was a small undertaking and confined to retail merchandising but as the

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[2] These items are listed in the findings as follows:

"Item	Amount
"Petty cash and change fund	$ 598.00
"Accounts Receivable	89328.54
"Unexpired Insurance	636.40
Total	$90562.94
"Less: Accounts Payable	52614.17
"Balance	$37948.77"

[3] In the place of the cancelled notes for $50,000 and $37,948.70, a note for $29,316.26 was issued to each partner, payable 6 years from date. In lieu of the cancelled note for $86,622.49, each partner received a note for $28,874.16 payable in annual installments of not less than $6666.66. All notes bore interest at 5 per cent per annum and the previously executed chattel mortgages were made to stand as security for the payment of the new notes.

years went on the business was successful and the company branched out into the wholesale and manufacturing ends of the paint business. The existing business was sufficiently well established that the interested parties could justly contemplate that the notes issued would be paid off out of earnings of the business in a relatively short period.[4] These expectations proved well founded and so, in 1946 and 1947, the earnings of the business were such that the corporation paid to each of the partners upon their $28,874.16 notes, not merely the $6666.66 called for, but the sum of $7500 was paid upon principal in 1946, and $10,000 was paid upon principal in 1947.

The general favorable earning capacity of the corporation and its business is indicated by the fact that in the estimate of Herbert Miller his 100 shares of the capital stock of Miller Paint Co., Inc., was valued for estate tax purposes at $347.78 per share; this as of February 13, 1948, approximately a year and one-half after the tranfers to the corporation. This value was based upon the average earnings of the partnership and the corporation projected over a period of ten years, with an allowance for management, and capitalized at the rate of 20 per cent. This indicates an enterprise with substantial good will; and since the record shows no reason for inferring a marked change in the business between the date of the transfers to the corporation, and the date of Herbert's death, it may fairly be assumed that from the initiation of the corporation, the corporate stock reflected values based upon probable earning capacity of approximately 300

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[4] From the Tax Court's opinion: "To be sure, the partners undoubtedly expected, as contended by petitioner, earnings to be sufficiently high that in a relatively short time they would be able to withdraw sums approximating in amount their original capital investment without impairing necessary capital; and subsequent events seem to prove this expectation to have been justified."

times $347 per share, or somewhere in the neighborhood of $100,000.[5]

It will thus appear that the arrangements made by the parties, and here described, were calculated to accomplish two objectives. The first objective was to set up the business in such form that its continuity would not be affected by Herbert's impending death and his son, for whose welfare all brothers manifested great solicitude, could step into his shoes and go forward with a continuing business. The second objective was to separate from the enterprise and place into the hands of the individual partners, the substantial amounts of cash which the partnership had accumulated and had on hand, and also make available to them individually, the proceeds of the notes which were issued and which it was anticipated would be paid when due and as provided in the notes. So far as Herbert was concerned, the notes would constitute a portion of an estate created for the benefit of his family in the event of his death.[6]

As before indicated, the controversy here arose out of the insistence of the Commissioner that the notes issued to Herbert Miller did not create a bona fide debtor-creditor

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[5] The value of the stock in February, 1948, would be some evidence of its value in May or June, 1946, in view of the apparent continuity of the business involved and the absence of anything to show reason for change in the interim. See Wigmore on Evidence, 3d ed., §§ 437, 463.

[6] These dual objectives are stated in the findings of the Tax Court in the following language: "Decedent was the only partner with children. Ernest was married but had no children, while Walter was unmarried. The three brothers desired an arrangement whereby death or incapacity of a partner would not affect the continuity of the business, the business could carry on free of interference in case of possible complications in the eventual probate of an estate, and an estate could be created for the benefit of a decedent's family in case of his death. In addition, Ernest wished to leave his share of the business to some employees without disturbing management and control."

relationship, and the payments to him in the years 1946-1947 of $7500 and $10,000 respectively, upon the principal of one of said notes, represented dividend distributions to that extent. The Tax Court's determination, supporting the Commissioner, was based upon three grounds. The first was that there was no intent that the notes would ever be paid; the second was based upon the alleged thin capitalization of the corporation; and the third reason was that the whole arrangement was lacking in "business purpose". We find ourselves unable to agree with the reasons given by the Tax Court for its determination.

With respect to the first point made by the Tax Court, it said: "Although the notes in form are absolute, and call for fixed payments, we have no doubt, from a reading of the entire record, that no payment was ever intended or would ever be made or demanded which would in any way weaken or undermine the business." A careful reading of the record discloses to us no basis for that conclusion. There is nothing ambiguous about the terms of the instruments or the obligations set forth in the notes themselves. As the Tax Court itself noted, "this is not a case involving 'hybrid securities', a term generally used to describe corporate instruments bearing indicia both of evidence of indebtedness and of capital investment". It is true that it was contemplated that the notes would be paid out of the earnings of the corporation, but the most excellent record of the past earnings of this same business was such that this was a reasonable contemplation. Many borrowers rely upon expected earnings for payment of their debts. We cannot see any justification for inferring that a promissory note is unreal and not representative of the actual arrangement merely because the maker expects to pay out of future earnings.

But what the Tax Court and the Commissioner have overlooked is the fact that not only the lawyer who arranged the transfer to the corporation and the execution of the

notes, and drafted the will of Herbert Miller, but the other Miller brothers as well knew that Herbert's will provided for the creation of a trust to hold both the shares of stock in the corporation and the notes here in question and the proceeds of the notes were to be reinvested by the trustee, the petitioner bank, for the benefit of Herbert's widow. It was known that Herbert had but a short time to live, and that the trustee would hold the notes and as a trustee be obligated to enforce them. We think that this situation positively negatives any inference of an intent that the notes would not be paid.[7]

The Tax Court placed much emphasis upon what it called "an absurdly low capitalization" of the corporation. While the court expressly disclaimed any intent to decide whether inadequate capitalization in and of itself would authorize the court to disregard as genuine the purported indebtedness,[8] it did discuss at length cases dealing with the so-called "thin capitalization" question.[9]

The findings of the Tax Court referred to the declared value of $1050 set upon the organization of the Oregon cor-

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[7] The facts here are to be contrasted with those in Gooding Amusement Co. v. Commissioner, 6 cir., 236 F. 2d 159, where a divided court approved a finding that the holders of the notes issued to the stockholders did not intend that the note should be collected and that the notes were a sham. In that case, although notes aggregating over $200,000 had been issued, only some $5000 had been paid on the notes which had been issued in series, and most of the notes were long past due. There the circumstance that the notes were not in fact paid could conceivably give rise to an inference that they were not intended to be paid. That situation contrasts with the one here where the amounts actually paid were in excess of the amounts due and owing.

[8] Said the Tax Court: "We do not have to decide here whether inadequate capitalization standing alone justifies the treatment of amounts alleged to represent indebtedness as invested capital."

[9] For a recent discussion of this problem which alludes to this case in the Tax Court, see "Thin Capitalization: Some Current Questions" by Boris I. Bittker, 34 Taxes, 830, (Dec. 1956).

poration. The findings, however, fail to note that the best available evidence upon the subject, namely, that furnished by the estate tax appraisal previously referred to, indicates that the declared value had no relation whatever to the real values of the corporation stock. When those facts are taken into consideration, it seems apparent that there was no disproportionate ratio of debt and capital in this case. If the capital stock was worth $100,000, or thereabouts, as has been indicated, an indebtedness of $174,000 would not be disproportionate, and no such ratio has ever been held to create a fatally thin capitalization. As stated by the Court of Appeals for the Second Circuit in Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127: "We think it obvious that in the determination of debt-equity ratios, real values rather than artificial par and book values should be applied." [10]

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[10] The quoted language is in line with other decisions of the Tax Court. Thus in Sheldon Tauber, 24 T.C. 179, four partners transferred their business to a corporation. The corporation issued to each of them "25 shares of its capital stock for $1.00 per share". This added up to a total of $100. They also took notes of the corporation for sums aggregating $209,000. The Tax Court said: (pp. 181-182) "Existing business conditions and prospects for future business conditions for the partnership were excellent at the time of the transfer. The partnership at that time had orders for over $500,000 worth of business. The fair market value of the assets and business transferred to the corporation at the time of the transfer was at least $150,000 in excess of the total asset values then shown on the books of the partnership and of the corporation. . . .

* * *

"The evidence shows that that excess was a substantial amount, probably in excess of $150,000. Thus, the initial capital of the corporation was not merely the $100 of cash paid in by the four individuals and shown as capital on the books of the corporation, but was a much larger amount not shown on its books which was nevertheless available as working capital. The total capital of the new corporation could not fairly be called 'thin'." (pp. 183-184) cf. Ainslie Perrault, 25 T. C. 439: "But we think the respondent has overlooked the fact that in addition to the assets which the Corporation purchased for a total consideration of $1,026,951.32

In holding that a business purpose was wanting here, the Tax Court said: "The record in the instant proceeding satisfies us that there was no valid business purpose which dictated the gross undercapitalization here present. There seems to be no question that sound reasons existed for forming a corporation to carry on the business, which had been operating up to that time as a copartnership, but every advantage sought through incorporation, except that of the avoidance of taxes, could have been accomplished with equal facility and assurance of success by the more normal method of the issuance of capital stock of the par or declared value more nearly commensurate with the total amount permanently contributed to the corporation, and with which it was expected thereafter to conduct its affairs." We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowledge that the choice of procedures in this regard will vary from corporation to corporation and we think that it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as "normal", and hence subject to approval by the Commissioner.

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it also acquired from the partnership for no consideration orders or unbilled items and goodwill having a substantial value to the Corporation of, to-wit, several hundred thousand dollars. The petitioners point to the fact that the Corporation realized from the rental contracts which were transferred to it on organization a total of $928,248.73. They also argue that goodwill of over $600,000 passed from the Partnership to the Corporation. We have not thought it necessary to determine the value of each separate asset that passed to the Corporation, but we have no hesitation in determining that they were of large value amounting to several hundred thousand dollars and constituted such an ample investment in the Corporation as to preclude any justification for holding under the thin capitalization doctrine that the transferred assets under the purchase agreement of January 5, 1948, should in substance be considered capital rather than a bona fide sale by the stockholders to the Corporation."

Of course, transactions no matter in what form, may be disregarded if they are a sham or masquerade. In this connection it is of importance to inquire whether the arrangements adopted have no purpose germane to the conduct of the business of the parties other than tax minimization. Gregory v. Helvering, 293 U.S. 465. It cannot be said that the parties had no intent to create a genuine indebtedness since the written instruments objectively manifest their intent to do just that. There is no evidence that this precise arrangement would not have been made and found desirable by the parties even though no tax consequences were involved. As the facts disclose, all the brothers were alike interested in arranging for perpetuation of the business for the benefit of Herbert's son and to take care of the old employees for whom Ernest wished to provide. For this reason they wanted a corporation and they set it up. At the same time they wanted to provide a means whereby Herbert's wife would take an easily liquidated estate with income definitely available to her. Had Herbert's interest been represented solely by stock in the corporation his wife, after his death, would have been dependent upon the declaration of dividends and over this, she, as a one-third owner, would have no control. She would have no protection against the draining off of a substantial portion of the income of the corporation, through salaries to corporate officers. These are matters which the brothers had a right to take into consideration when they decided how they would extend financing to the corporation. All of these were non-tax objectives, and we think that the evidence here shows an adequate and sufficient business purpose to demonstrate conclusively that the arrangement was no sham.

We hold, therefore, that the assessment of a deficiency was erroneous, and the decision of the Tax Court is reversed.

(Endorsed:) Opinion. Filed Dec. 27, 1956.

PAUL P. O'BRIEN, *Clerk.*

APPENDIX D

Statutes Involved

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations * * * the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) [As amended by Sec. 213 (c) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(26 U.S.C. 1952 ed., Sec. 115.)

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 709

GOODING AMUSEMENT COMPANY, INCORPORATED, F. E. GOODING, ELIZABETH GOODING, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 128a–153a) are reported at 23 T. C. 408. The opinion of the Court of Appeals (Pet. 17–32) is reported at 236 F. 2d 159.

JURISDICTION

The judgments of the Court of Appeals were entered on August 1, 1956. (Pet. 33–36.) A motion for an extension of time within which to file a petition for rehearing was filed in the Court of Appeals on August 20, 1956, and was granted, extending such time to September 15, 1956. (R. 177a.) A petition for rehearing was filed on September 13, 1956 (R. 178a)

and an order denying the petition was entered by the Court of Appeals on October 26, 1956. (R. 179a.) The petition for a writ of certiorari was filed on January 23, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the record warrants the Tax Court's determination, affirmed by the court below, that notes issued by a family corporation to its stockholders (taxpayers) together with and in proportion to its original stock issue, in exchange for the initial assets of the corporation, were intended to and did in fact evidence capital contributions rather than bona fide loans to the corporation.[1]

STATUTES INVOLVED

The pertinent provisions of Sections 23 (b), 112 (b) (5), 113 (a) (8) and 115 (a) of the Internal Revenue Code of 1939 are set forth in the Appendix, *infra*, pp. 12–14.

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[1] Upon the answer to this underlying question turns the answer to the following specific questions raised by the petition for certiorari:

1. Whether accruals of purported interest on the notes were deductible as such by the corporate taxpayer under Section 23 (b) of the Internal Revenue Code of 1939.

2. Whether payments of purported principal on the notes constituted taxable dividends under Section 115 (a) of the Internal Revenue Code of 1939.

3. Whether the exchange by the corporate taxpayer of its stock and notes for the assets transferred to it by its stockholders constituted a nontaxable exchange under Section 112 (b) (5) of the Internal Revenue Code of 1939, so that the basis of the assets in the hands of the corporation was the same as in the hands of the transferor-stockholders.

STATEMENT

The facts as found by the Tax Court (R. 129a–143a) and stated by the Court of Appeals (Pet. 18–31) may be summarized as follows:

In 1932, F. E. Gooding (hereinafter called taxpayer) organized a corporation to lease and operate merry-go-rounds, ferris wheels and similar amusement devices, which were owned by him individually. This corporation was dissolved on December 31, 1942. (Pet. 18.)

On January 1, 1943, taxpayer formed a partnership with his wife, Anna Elizabeth Gooding, and their one-year-old daughter, and sold the amusement devices to this partnership. Taxpayer gave his wife a two-sevenths' interest in the partnership and his child a one-seventh interest, retaining the remaining four-sevenths' interest therein. (Pet. 18, 19.)

On August 24, 1946, taxpayer organized the Gooding Amusement Company, Incorporated (hereinafter called the corporation), with taxpayer as president and treasurer, Mrs. Gooding as vice-president, and Kathleen Holleran as secretary. On that date, the partnership distributed to its three partners, as tenants in common, various assets; a four-sevenths undivided interest was distributed to taxpayer, two-sevenths to Mrs. Gooding, and one-seventh to the infant daughter. The book value of these assets was $177,037.29. (Pet. 19.) Of this amount, $130,000 consisted of trucking equipment and mechanical rides (Pet. 20). Each partner, in proportion to his or her respective undivided interest in the distributed assets, assumed a joint and several obligation to pay certain notes executed by the partner-

ship in the total amount of $13,969.25. The net total distribution was thus $163,068.04. Other assets of the partnership remained undistributed, the partnership remaining in existence. The book value of these undistributed assets was $285,745.84, of which $184,444.23 was in cash. (Pet. 19, 21.)

Concurrently with the distribution of the partnership assets, the partners transferred such distributed assets to the newly formed corporation, valuing them at $294,970.39. The difference between the depreciated book value of these assets ($177,037.29) and the offering price thereof ($294,970.39) represented the difference between the book value and the fair market value, as appraised by the taxpayer and the secretary of the corporation, of the trucking equipment and mechanical rides. The corporation also assumed the $13,969.25 of partnership notes, which had previously been assumed by the three partners. (Pet. 20.) The corporation received no cash whatever from the partners. Also, although the name "Gooding" was of established value in the outdoor amusement field, no good will value was ascribed to it on the books of either the partnership or the corporation. (Pet. 21.) Similarly, certain "privilege" contracts owned by the partnership, which gave taxpayer the use of certain locations on which the amusement devices could be placed, were not carried on the books of the corporation. (R. 132a, 136a.)

In return for the transfer of the foregoing assets, amounting to a net balance of $281,001.14, the partners each received, in proportion to their respective partnership interests, shares of no-par value stock and

five notes of the corporation, due in five succeeding years (beginning in 1947) (Pet. 20–21). The total stated value of the stock was $49,000 and the total principal amount of the notes was $232,001.14.[2] (R. 136a, 141a.) The portion of the assets contributed for the shares and notes, respectively, was not identified. The notes were ordinary negotiable instruments, each containing an unconditional promise to pay the principal, at a fixed maturity date, together with interest at five percent per annum. The notes to the infant daughter were payable to taxpayer, as guardian of the daughter. (Pet. 21.)

As of December 1953, the corporation had paid Mrs. Gooding only $5,000 on the series of five notes for $13,257.21 payable to her and had made no payments on the series of five notes for $6,628.60 payable to the infant daughter. The corporation still owed taxpayer the principal amount due on two notes of $26,514.41 each. All the unpaid notes were long past due. Taxpayer had been paid the principal on three of the notes, two due in 1947 and 1948 being paid on or about the maturity date and one due in 1949 being paid in 1950; each of the notes were paid taxpayer for the reason, stated by him, that, unlike Mrs. Gooding and the infant daughter, he needed money for investment in an apartment house. (Pet. 22; R. 141a.) The

[2] Each partner reported for the taxable year 1946, as long-term capital gain, his or her proportionate share of the difference between the depreciated cost of the transferred assets and the amount at which such assets were offered to and accepted by the corporation, paying a total tax thereon of $28,683.27, which the Commissioner accepted. (Pet. 21.)

corporation only paid one-fourth of the interest owing to taxpayer in 1947 and made no interest payment to Mrs. Gooding and the infant daughter. Thereafter, the corporation paid interest on the notes as it fell due, although it is not clear from the record whether interest payments continued after maturity of the notes. (R. 142a.)

Between August 24, 1946, and December 31, 1952, the corporation sold about 15 per cent of the trucking equipment and 57 per cent of the mechanical rides originally acquired from the partnership, for a total sales price of $112,067.10 (including trade-in values received). The corporation acquired new equipment and rides at a total cost of $306,894.27 during 1947. For the acquisition of additional equipment in 1947 and in later years, and for its operation, the corporation obtained funds and credits, evidenced by notes, from banks and other third-party creditors, the partnership, taxpayer and the infant daughter. These notes payable amounted to $138,572.08 in 1947, $186,018.92 in 1948, and $246,149.40 in 1949. During 1947, the partnership and the infant daughter advanced the additional sum of $23,000 to the corporation. Of this amount, $17,000 was outstanding at the close of 1947 and 1948, and $14,000 was outstanding at the close of 1949. (Pet. 21–22; R. 137a–139a.) The principal amounts of the unpaid notes held by taxpayer, Mrs. Gooding and the infant daughter were not paid because the corporation was heavily indebted to outsiders and at no time during the period involved had a sufficient cash balance. Taxpayer, who as president and majority stockholder controlled the corporation,

subordinated the claims of himself and his family to those of the banks and other third parties. Taxpayer felt that such subordination was necessary in order to maintain the corporation's credit standing. Taxpayer and his family at no time had any intention of enforcing their matured claims against the corporation. (Pet. 23.)

The Tax Court, based upon the foregoing and other facts, found as an ultimate fact that the issuance of the notes on August 24, 1946, did not establish the relationship of debtor-creditor between the corporation and the individual members of the Gooding family. (R. 143a.) Accordingly, the Tax Court held that the amounts paid and accrued by the corporation as interest were not deductible as such by the corporation; that the payments of principal on the notes were taxable to the recipients as dividends; and that the transfer of assets on August 24, 1946, was a non-taxable exchange, with the result that the basis of the assets in the hands of the corporation, for purposes of computing depreciation expense and gain or loss from the sale thereof, was the same as the basis of the assets in the hands of the transferors, the Gooding family. (R. 148a–151a, 153a.)

The Court of Appeals held that the findings of fact of the Tax Court were supported by substantial evidence and were not clearly erroneous. It accordingly affirmed.

ARGUMENT

1. As both courts below pointed out in their carefully reasoned opinions, whether the issuance of a so-called debt instrument by a corporation to its controlling stockholders is intended to reflect a bona fide indebtedness as distinguished from a capital interest presents a question of ultimate fact in each case, depending on all the relevant circumstances, no single factor being conclusive. The courts of appeals, including those with whose decisions taxpayer alleges conflict, have uniformly so held.[3]

The evidence recited in detail by both courts below fully warrants the Tax Court's conclusion that the notes in question represented a proprietary stockholder interest in the corporation rather than a genuine debtor-creditor relationship, *i. e.* a contribution to the capital of the corporation rather than a loan to it. That the notes were subordinated to claims of third parties, and that only a small portion of their amount had been paid at maturity, are features which in and of themselves furnish substantial evidentiary support for that conclusion. Certainly the Tax

[3] See, e. g., *Washmont Corp.* v. *Hendricksen*, 137 F. 2d 306 (C. A. 9th); *Matthiessen* v. *Commissioner*, 194 F. 2d 659 (C. A. 2d); *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. 2d 644 (C. A. 3d); *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. A. 7th); *Wetterau Grocer Co.* v. *Commissioner*, 179 F. 2d 158 (C. A. 8th); *Earle* v. *W. J. Jones & Son*, 200 F. 2d 846 (C. A. 9th); *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904 (C. A. 10th).

Court's determination of the actual intent of the parties cannot be said to be clearly erroneous on the record here presented, and under familiar principles governing the scope of appellate review of such findings the court below properly refused to disturb it. *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 341; *John Kelley Co.* v. *Commissioner*, 326 U. S. 521; *Wilmington Co.* v. *Helvering*, 316 U. S. 164, 168. And since the issue is one of fact, the concurrent findings of both courts below are entitled to finality here. *Comstock* v. *Group of Investors*, 335 U. S. 211, 214.

2. There is no conflict of decisions. As the court below observed (Pet. 28–29), the cases dealing with the issue here presented are legion, and "each depends for its solution upon its own peculiar facts." If any comparison is to be drawn between this case and others, however, the cases relied upon by the court below (Pet. 28–30), rather than those mentioned by taxpayer, furnish closer analogies on their facts.

In *Estate of Miller* v. *Commissioner*, decided by the Ninth Circuit on December 27, 1956 (Pet. 37; 1957 C. C. H., par. 9277), upon which taxpayer chiefly relies, the court expressly distinguished the instant case on its facts. Noting that in the instant case the major portion of the notes remained unpaid and outstanding at their due dates, while in *Miller* amounts in excess of those owing were paid, the court "contrasted" the two situations and observed that the facts of the instant case, unlike those in *Miller*, warranted an infer-

ence that the notes "were not intended to be paid" (Pet. 44).[4]

In *Sun Properties, Inc.* v. *United States*, 220 F. 2d 171 (C. A. 5th), upon which taxpayer also relies for conflict, the court applied the same basic principles as were applied by the courts below in this case, but held that the trial court's conclusion that a contribution to capital rather than a sale was there intended lacked evidentiary support. Significantly, in so holding it enumerated as some of the relevant factors tending to show that a payment is intended to be a capital contribution, the following (pp. 175–176): that repayment is subordinated to other indebtedness; that the parties agree not to enforce collection; and that the payment occurs at the formation of the corporation. These very factors—absent in the *Sun Properties* case, but present in this one—serve to differentiate the two cases in vital respects.

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[4] Other facts peculiar to the *Miller* case which supported the court's holding with respect to intent to repay the notes were: (1) the excellent prospect based on the surrounding circumstances that the notes would be paid out of the earnings of the business in a relatively short period, whereas in the instant case the corporation was faced with the prospect of large capital investments requiring loans from third parties, without any corresponding prospect of a liquid cash position to pay both the third parties and the family-creditors; (2) the unusual circumstance that one of the partners had been stricken with cancer and had but a short time to live, a fact known to all concerned at the time of incorporation, and that it was contemplated that the notes issued to him would be assigned to an independent trustee, who would enforce them for the benefit of his devisees; (3) the presence of strong business purposes (absent in the instant case) which the court recognized in holding the transaction to be bona fide.

As for *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C. A. 2d), with which taxpayer asserts conflict "in principle" (Pet. 12), it suffices to note that the Second Circuit has repeatedly treated the issue as one of fact depending upon the intention of the parties,[5] and it has since confined its *Kraft* holding to the particular facts there presented. *The Gregg Co. of Delaware* v. *Commissioner* (decided December 17, 1956, 1957 C. C. H. par. 9256).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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Solicitor General.
CHARLES K. RICE,
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HARRY BAUM,
SHELDON I. FINK,
Attorneys.

FEBRUARY, 1957.

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[5] See, e. g., *Mathiessen* v. *Commissioner*, *supra*; *1432 Broadway Corp.* v. *Commissioner*, 160 F. 2d 885; *Janeway* v. *Commissioner*, 147 F. 2d 602; *Prutzman* v. *Commissioner*, 218 F. 2d 603; *Bair* v. *Commissioner*, 199 F. 2d 589; *Powers Photo Engraving Co.* v. *Commissioner*, 197 F. 2d 704; *Bachrach* v. *Commissioner*, 205 F. 2d 151.

APPENDIX

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SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations * * * the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) [As amended by Sec. 213 (c) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Exchanges Solely in Kind.*—

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(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a

transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

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(26 U. S. C. 1952 ed., Sec. 112)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

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(26 U. S. C. 1952 ed., Sec. 113)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

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(26 U. S. C. 1952 ed., Sec. 115)

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